The Impact of the Capital Purchase Program and Bank Lending

One important tool that has been implemented over the last several months to deal with the worsening financial situation is the Capital Purchase Program (CPP) of the Troubled Asset Relief Program (TARP). It is a program that encourages FDIC-insured banking institutions that are healthy to sell senior preferred shares to the government. The CPP's purpose, according to Treasury, is to increase the capital position of the banking sector (even though the great majority of banks are well capitalized) in order to stabilize the financial markets and provide the strong foundation on which an economic recovery can be built through the increased provision of sound credit. This is a role America's banks are committed to carry out.

Genesis of the Capital Purchase Program

It is important to remember the history of this government intervention. The genesis of the CPP was the severe problems at firms that were ***not*** banks, such as Bear Stearns, Fannie Mae and Freddie Mac, and AIG. Then, when international credit markets froze, the Treasury and the Federal Reserve created, virtually overnight, the CPP for healthy banks. While the economic problems have spread to include some banks, the vast majority of banks never made a toxic subprime loan, and these banks remain strong, despite the spreading economic downturn.

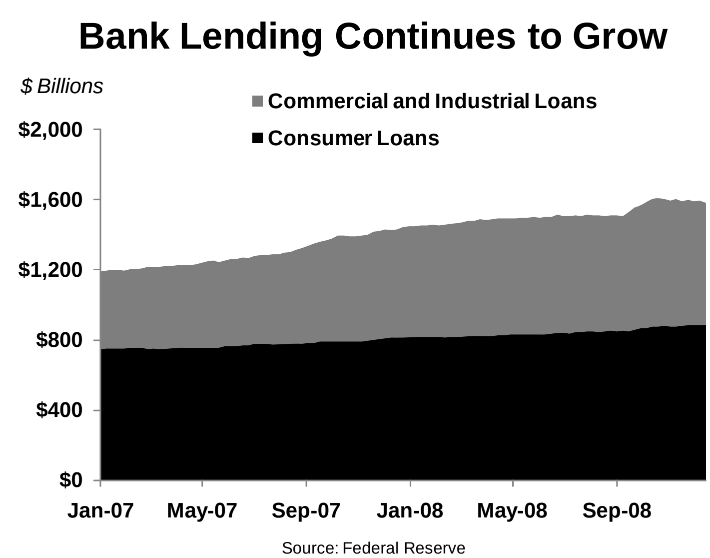
The U.S. action to inject capital into healthy banks was also a response to foreign governments acting to support institutions that were far less capitalized than U.S. banks. U.S. banks typically had three times the capital of their foreign counterparts and twice the capital of Wall Street investment banks. In fact, at the end of the third quarter, more than 95 percent of U.S. banks were well-capitalized.

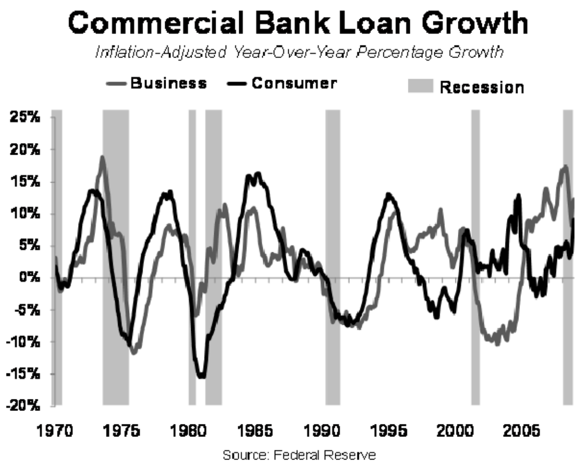
Capital Injection Can Support New Lending

Treasury provided investments in banks to build strong capital to withstand a deep recession and to support new lending. One dollar of capital can support much more than $1 of lending – up to $7. This is good news for the communities where these banks are located. However, the impact is not immediate. New loans need to be funded with new deposits, which have to be raised. Moreover, many banks that applied have yet to receive their funds and more than one-third of banks have had no opportunity to apply to the CPP as Treasury only very recently released term sheets S-corporation banks and have not issued terms for mutual savings banks. At this point, less than five percent of banks have CPP funding. It is estimated that less than 25 percent will choose to participate.

Banks Continue to Lend in this Weak Economy

Even with the economy faltering and individuals and businesses reducing their borrowing, banks continue to lend. This is, in fact, in sharp contrast to the lending trends during other recessions. Typically, as the chart and table on the following page show, loan growth shrinks during a recession as loan demand falls. During the current recession, business loans have ***expanded*** by 12 percent and consumer loans by 9 percent; in contrast, median business loans ***declined*** by 0.7 percent and consumer loans by 5.1 percent for the previous six recessions.





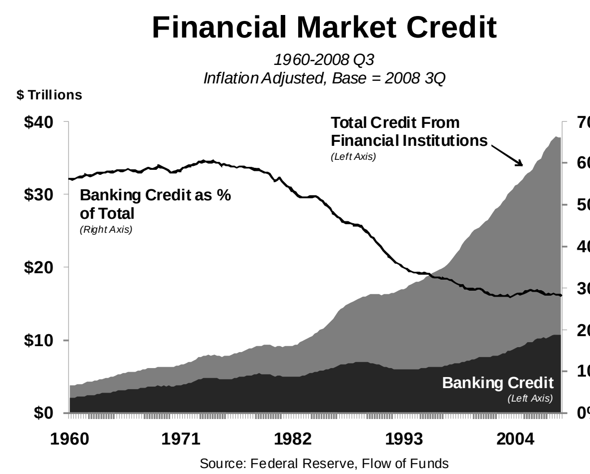
Change in Bank Lending and Capital During Recessions[1]

Recession	Business (%)	Consumer (%)	Average Capital-To-Asset Ratio (%)	Change in Capital-to-Asset Ratio (Basis Points)[2]
Dec 1969 - Nov 1970	-0.9	-1.2	N/A	N/A
Nov 1973 - Mar 1975	5.7	-6.3	4.7	20
Jan 1980 - Jul 1980	-0.5	-12.8	5.0	-134
Jul 1981 - Nov 1982	9.0	-4.4	5.4	205
Jul 1990 - Mar 1991	-6.6	-5.9	8.2	52
Mar 2001 - Nov 2001	-8.0	1.9	9.6	88
Median of Past Recessions	**-0.7 %**	**-5.1 %**	**5.4 %**	**70 bp**
Dec 2007 - ?	**12.2 %**	**9.0 %**	**10.5 %**	**-104 bp**

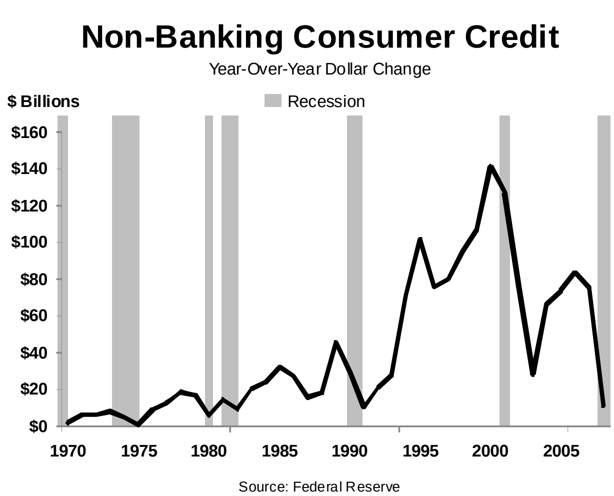
1. Twelve-month change from the month prior to the official start of the recession.
2. One basis point equals $1/100^{th}$ of a percentage point.
Source: Federal Reserve, H.8, Assets and Liabilities of U.S. Commercial Banks

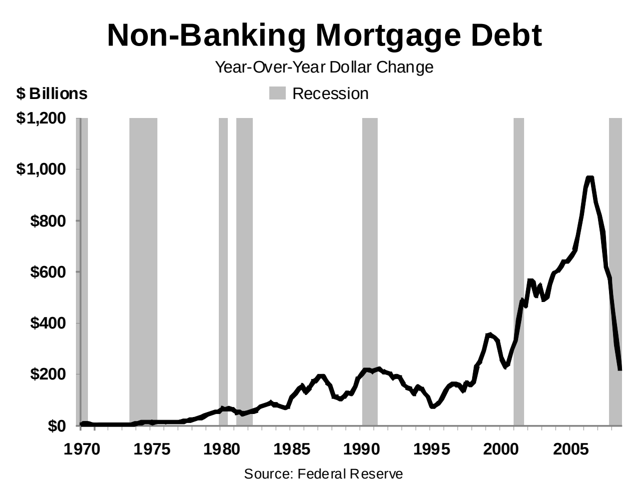
Most New Credit is from Traditional Bank Lending, as Non-Bank Credit Has Shut Down

While banks have been lending, they cannot offset the dramatic fall off of credit ***outside*** the banking industry. Thirty years ago, banks provided about 60 percent of all credit – today ***traditional bank lending provides less than 30 percent.*** The collapse this past year of the secondary markets for mortgages and other consumer credit products, such as credit cards and auto lending, has taken out an important pipeline of credit. Thus, many of the stories about the lack of credit are due to the weakness of ***non-bank*** lenders and the weakness of the securitization markets.



When non-bank sources of funds disappeared following the bankruptcy of Lehman Brothers and emergency support for AIG, Fannie Mae and Freddie Mac, large businesses turned to banks to meet their short-term credit needs. ***Without bank financing for businesses – which increased by <u>$345 billion</u> from September 10 to October 22 alone – the crisis would have been much greater as payrolls and payments to suppliers would have been disrupted.***





What Others Are Saying: Robert J. Samuelson *The Washington Post,* Feb.9, 2009

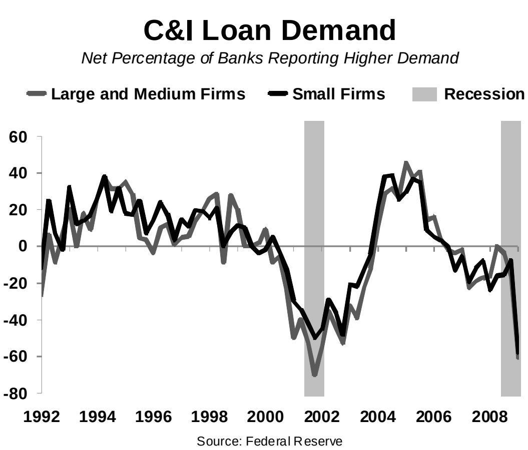
"So, we've gone from too much credit to too little. Contrary to popular wisdom, banks – institutions that take deposits—aren't the main problem. In December, total U.S. bank credit stood at $9.95 trillion, up 8 percent from a year earlier, reports the Federal Reserve. Business, consumer and real estate loans all increased. True, lending was down 4.7 percent from the monthly peak in October. But considering there's a recession, when people borrow less and banks toughen lending standards, the drop hasn't been disastrous.

The real collapse has occurred in securities markets. Since the 1980s, many debts (mortgages, credit card debts) have been "securitized" into bonds and sold to investors – pension funds, mutual funds, banks and others. Here, credit flows have vaporized, reports Thomson Financial. In 2007, securitized auto loans totaled $73 billion; in 2008, they were $36 billion. In 2007, securitized commercial mortgages for office buildings and other projects totaled $246 billion; in 2008, $16 billion. These declines were typical.

Given the previous lax mortgage lending, some retrenchment was inevitable. But what started as a reasonable reaction to the housing bubble has become a broad rejection of securitized lending. Terrified creditors prefer to buy "safe" U.S. Treasury securities. The low rates on Treasuries (0.5 percent on one-year bills) measure this risk aversion."

Banks entered this current recessionary period with much higher capital compared to other recessions (see the table on the previous page). Loan losses have increased as the economy weakened; as capital absorbed these losses, capital ratios began to fall somewhat.

Under normal circumstances, banks would go to the private capital markets for additional capital. With markets frozen, this has been extremely difficult to do. In fact, banks in the last 12 months have ***raised only one-third of capital typically raised during a recession,*** according to the Federal Reserve. Without additional capital to back more loans, banks might not be able to grow lending; others might even be forced to shrink lending in order to boost their capital-to-assets ratio. The Capital Purchase Program investments will provide capital to support lending and also make it easier for banks to raise capital directly as investors will have more confidence in the overall financial underpinning of the bank.



Naturally, banks are following prudent underwriting standards to avoid losses in the future, and bank regulators demand that they do so. But in spite of the difficult economic environment, only 7 percent of small businesses (according to a December survey by the National Federation of Independent Businesses, NFIB) reported problems in obtaining the financing they desired. The report noted that: "The credit worthiness of potential borrowers has also deteriorated over the last year, leading to difficult terms and higher loan rejection rates, even with no change in lending standards."

Borrowers are also being more careful, and, as would be expected in this economy, the overall demand for loans is declining, although this varies by market. (See the chart on Commercial and Industrial Loan Demand.) The NFIB reports that "only 31 percent [of businesses] reported regular borrowing, down two points and equal to the 35-year, record low reading." This combination of ***increased*** bank lending in 2008 at the same time that loan demand was ***shrinking*** underscores the increased prominence of banks in meeting the credit needs of borrowers.

It is almost certain that loan demand in this economy will continue to decline, and there is evidence that traditional bank credit is now marginally declining. With fewer customers, businesses experience a reduction in the need to finance inventory, buy equipment or expand operations. Nervousness about job security makes individuals less willing to borrow. As the chart on the right shows, it often takes several years to reverse the impact of a recession. However, as the economy starts to grow again and loan demand increases, the ability of banks to meet these needs will be stunted if adequate capital is not available to back increased lending.

Months for C&I Loans to Recover to Pre-Recession, Inflation-Adjusted Level

Recession Starting Year	From Start of Recession	From End of Recession
1948	22	10
1953	24	13
1957	21	12
1960*	N/A	N/A
1969	15	3
1973**	N/A	N/A
1981***	22	15
1990	81	72
2001	79	70
Median	**22**	**13**

*Outstanding loans grew through recession
**Outstanding loans grew through recession; however, fell sharply in years following recession
***The dual 1981 and 1982 recessions were calculated as a single recession.
Source: Federal Reserve H.8, data for commercial banks only

The Need for Clarity

The ever-changing nature of TARP has created great confusion. Clear-cut distinctions between programs within TARP are needed. For example, the CPP should be separated from programs to address problems of systemically important institutions. Only by clearly identifying the programs (and the costs of each) can there be proper Congressional oversight and effective policymaking. The public's confusion undermines confidence in the efforts to turn around the economy. The CPP program is different from systemic risk support, as the side-by-side table below shows.

Capital Purchase Program	Other TARP Systemic Risk Programs
For institutions that are ***healthy*** at the time investments are made; explicitly ***not*** for troubled companies.	For companies considered to ***pose systemic risk*** that request government assistance.
The government created the program; the banking industry did not ask for it. ***Voluntary***, but government has requested that some banks participate.	Companies ***ask*** for assistance.
Purpose is to ***stabilize financial markets*** by providing capital to healthy institutions and increasing the flow of credit to businesses and consumers.	Purpose is to ***aid companies thought to be in difficulty*** that could have a systemic impact.
Government determined same terms for all participants. No input on terms from participants.	Rescues have been ***individually negotiated with participants***.
Government ***certain*** to receive tens of ***billions of dollars*** from dividends paid by participants on CPP investments. Warrants will almost certainly be worth billions more.	Final ***cost*** of individual actions ***uncertain***.
Designed with exit strategy. Strong financial incentive for institutions to pay off government investments in ***five*** years.	***Exit strategy uncertain.*** How government involvement ends is, in some cases, uncertain.